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# THE CURRENCY-BANKING CONTROVERSY

A PART OF A DISSERTATION SUBMITTED TO  
THE FACULTY OF THE DIVISION OF THE  
SOCIAL SCIENCES IN CANDIDACY FOR  
THE DEGREE OF DOCTOR OF PHILOSOPHY

DEPARTMENT OF ECONOMICS

1941

By  
MARION R. DAUGHERTY

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# THE CURRENCY-BANKING CONTROVERSY

## PART I

MARION R. DAUGHERTY

*Mount Vernon, N. Y.*

The Currency-Banking controversy already has a familiar place in the history of economic thought, and this fact perhaps makes it necessary to indicate explicitly the intentions of what follows. While several excellent modern studies relating to this controversy exist, none of these has for its main purpose simply the telling of the story in a rounded way. Professor Viner's discussion,<sup>1</sup> is primarily concerned with the international trade theory aspects of the controversy. Professor Gregory, in the Introduction to his *Select Statutes, Documents, etc.*,<sup>2</sup> concentrates attention on the Currency School position, and in his *Introduction to Tooke and Newmarch's A History of Prices*,<sup>3</sup> he is, of course, mainly concerned with Tooke's place in the development of economic thought. Professor Elmer Wood's study, as the title indicates, consists chiefly of a topical sifting of the writings of the period for views on central banking control.<sup>4</sup> There would seem therefore to be room for the present survey, the aim of which has been to present a more complete—though necessarily summarized—account of the controversy in its background of ideas and events than is available elsewhere. It is hoped also that in the process of overhauling the original sources some new information may have been turned up, and also that some contribution may have been made in the way of reinterpretation of doctrine.

### I

The controversy between the Currency School and the Banking School arose in the second quarter of the nineteenth century over certain plans for the reform of the English currency system. These reforms, advocated by the Currency School, were finally embodied in what has since been known as Peel's Act of 1844, as a result of which competitive note issues were virtually eliminated in England, and the notes of the central issuing body, the Bank of England, were subjected to a form of regulation previously untried in any country. In principle this form of regulation remained in operation until England went off the gold standard in 1931.<sup>5</sup>

The theory behind the Act of 1844 originated in the years immediately following the Napoleonic Wars. In 1821, six years after the end of the Napoleonic Wars, England returned to the gold standard according to the provisions laid down in the Act of 1819. This Act ended a period of more than twenty years,

<sup>1</sup> *Studies in the Theory of International Trade*, 1937, ch. V.

<sup>2</sup> *Select Statutes, Documents and Reports Relating to British Banking, 1832-1928*, 1929.

<sup>3</sup> *London*, 1928.

<sup>4</sup> *English Theories of Central Banking Control, 1819-1858*, 1939.

<sup>5</sup> Its operation was also suspended during the first World War period when England temporarily abandoned the gold standard.

during which the country had used an inconvertible paper currency. The Chief preoccupation of economists during the war years had been to explain the depreciation of the pound in terms of gold and to urge a contraction of Bank of England note issues and a return to specie payments as a remedy. It seems to have been felt that if these steps were taken currency problems would be largely solved and a sound monetary system established.

In the twenty years following the resumption of cash payments, however, events took place which convinced many observers that grave defects still existed in the currency system. In the period 1821-1844, the problem, as seen by a large group of men, was that of maintaining the convertibility of bank note issues in the face of severe periodic drains of gold from the reserves of the Bank of England. Twice during the period the reserves of the Bank fell to levels at which drastic action was required to prevent complete exhaustion. It soon came to be said that it was not enough merely to declare the currency convertible, as had been done by the Act of 1819; it was argued that further measures should be adopted for safeguarding the Bank's reserves and thus for implementing the Act of 1819. The group of writers who took this view and who finally devised the remedies embodied in Peel's Act of 1844 were known as the Currency School.

The problem of maintaining convertibility was in this period closely connected with cyclical fluctuations of business activity, particularly the crisis phase. The severe outflows of gold which occurred in 1825 and again in the late thirties came at the end of periods of prosperity and were thought to be the main factor precipitating the crises which followed. The problem was accordingly thought of as being the dual one of protecting the Bank's reserves and at the same time of reducing the force of the crises. It may indeed be said that in this period it was the business cycle which largely determined the character of currency problems in contrast to other factors, such as the inconvertibility of notes or debase-ments of coinage, which were the dominant elements in currency problems of earlier years.

## II

Three severe financial and economic crises—those of 1825, 1836, and 1839—punctuated the period 1821 to 1844.<sup>6</sup> The pattern of these crises was fairly uniform, as may be seen from the accompanying chart. Each climaxed a year or more of rising prices and economic expansion and was followed by a serious reaction of prices. During each phase of rising prices the metallic reserves of the Bank declined with striking regularity, while during the depression phase gold flowed back to the Bank. With an upper limit during the period of around

<sup>6</sup> The most useful primary sources here were: Thomas Tooke and William Newmarch, *A History of Prices* (6 vols.; London; 1838-1857); Great Britain, House of Commons, *Report from the Committee of Secrecy on the Bank of England Charter*, London, 1832, and *ibid.*, *Reports from the Select Committee on Banks of Issue*, *Parliamentary Papers*, Vol. IV (1840), Vol. V (Jan.-June, 1841). The most important secondary sources were: A. E. Feavearyear, *The Pound Sterling*, 1931; J. H. Clapham, *An Economic History of Modern Britain*, 1926; M. Tugan-Baranowskii, *Les Crises Industrielles En Angleterre*, 1913.



twelve million pounds, the reserves declined to a low of about one million in the 1825 crisis, four millions in 1836, and two and a half millions in 1839. The drain of 1836 was the mildest of the three. Those of 1825 and 1839 were much more severe. In both cases about seven million pounds left the Bank in nine months. While data on the subject are fragmentary, it appears that a flow of gold abroad occurred on all three occasions, and on two, in 1825 and 1836, the drain was intensified by a domestic demand for hoarding.

The policy of the Bank of England during these troubled periods was such as to arouse much criticism. In every case the drain was allowed to go on for months and seriously to deplete the reserves before the Bank rate of discount was raised (as the chart indicates), before Exchequer bills were sold in the open market, or before any other corrective action was taken. When the Bank eventually took active steps to halt the gold outflows, the measures adopted came at a time when confidence was already impaired and apparently had the effect in two crises, those of 1825 and 1836, of worsening the situation and of accentuating, if not initiating, a panic internal demand for gold. In 1839, although there was little if any internal drain, there is some evidence that the foreign drain represented, at least in part, a flight from the pound, or in other words was of an inflammatory character comparable to the internal drains of the other crises. In the crises of 1825 and 1836 the Bank, after considerable hesitation, finally abandoned its restrictive policy and began discounting freely in order, in the phrase of the day, "to support commercial credit." It was this change of policy which apparently restored confidence, checked the demand for gold, and saved the reserves. In 1839 complete exhaustion of the reserves was only prevented, it seems, by the Bank's borrowing large sums in Paris.<sup>7</sup>

During the period 1821 to 1844, as the chart shows, the notes of the Bank of England did not by any means fluctuate one for one with the bullion in the Bank as, according to the Currency School, they should have done. While they did decline to some extent when the reserves were declining, the shrinkage in the note circulation was much less than that of the reserves. As far as the other banks of the country were concerned the record, judged by Currency School standards, was even worse. Their note issues seem to have followed the movement of general prices and to have undergone substantial expansion in each period of gold outflow from the Bank of England.

### III

By the time the Currency School came upon the scene in the eighteen thirties, their basic tools of thought relating to money, prices and the forces governing the international distribution of gold had long since been developed in the writings of Hume, Ricardo and many others. The first writers to foreshadow closely the particular distinguishing features of Currency views were, however, a group who

<sup>7</sup> An operation which was regarded by most contemporaries as disgraceful but, interestingly enough, by Gilbart as a sensible procedure for avoiding an international transfer of gold and a practice which might usefully be made permanent. See J. W. Gilbart, *Currency and Banking*, London, 1841, pp. 51-52.



debated the events of the crisis of 1825. These writers, in contrast to some of their contemporaries<sup>8</sup> who objected to the return to gold, or at least to the return as the pre-war parity, took as axiomatic the desirability of the gold standard. They formulated at least two important elements of Currency School theory. In the first place, they enunciated the view that mere legal convertibility was not sufficient to check overissue. Secondly, most of them took the view that currency reform must be in the direction of bringing the behavior of the existing mixed currency closer to that of a purely metallic currency. What they had in mind was that the mixed currency ought to vary quantitatively as a purely metallic currency was supposed to do according to the traditional theory of international gold movements. This view was, of course, the one which the Currency School held and which later came to be known as the "Currency Principle."

Richard Page,<sup>9</sup> Robert Mushet,<sup>10</sup> John Ashton Yates,<sup>11</sup> and Thomas Tooke<sup>12</sup> (at this time) favored an increase in the metallic portion of the currency by the substitution of coin for notes of lower denominations. Henry Drummond<sup>13</sup> put forward a plan almost identical with that of the Currency School. J. R. McCulloch<sup>14</sup> analyzed the events of the crisis in a manner similar to these writers, though without suggesting any plan of regulation along Currency School lines. Thomas Joplin,<sup>15</sup> similarly, closely anticipated Currency School views, though his plan for reform centered around the joint-stock banks rather than the Bank of England.

The main difference between the writings of this period and Currency School literature is that we do not find in the former a well-developed doctrine or a single plan unanimously supported. The earlier writers each suggested somewhat different schemes for reform which were only more or less close approximations to the plan embodied in the Peel Act of 1844.

The actual measures taken immediately by the Government in response to the disasters of 1825 were the abolition of small notes (those under five pounds) and the encouragement given to the establishment of joint-stock banks of issue and of branches of the Bank of England in the provinces.<sup>16</sup> In contrast to the

<sup>8</sup> For example, cf. (Thomas Attwood of Birmingham) *The Scotch Banker*, London, 1828; Sir John Sinclair and Thomas Attwood, *The Late Prosperity and the Present Adversity of the Country Explained*. . . London, 1826; C. C. Western, "A Letter to the Earl of Liverpool. . . ." *The Pamphleteer*, XVII (1826); Sir James Graham, *Corn and Currency*. . . , 2d ed.; London, 1826.

<sup>9</sup> *Letters to the Editor of "The Times Journal" on . . . the Bank of England*, London, 1826.

<sup>10</sup> *An Attempt to Explain . . . the Effect of the Issues of the Bank of England*, London, 1826.

<sup>11</sup> *Essays on the Currency and Circulation*, Liverpool, 1827.

<sup>12</sup> *Considerations on the State of the Currency*, 2d ed.; London, 1826.

<sup>13</sup> *Elementary Propositions on the Currency with Additions*, 4th ed.; London, 1826.

<sup>14</sup> "Thoughts on Banking," *Edinburgh Review*, XLIII (February, 1825), and "The Late Crisis in the Money Market," *ibid.*, XLIV (June, 1826).

<sup>15</sup> *An Illustration of Mr. Joplin's Views on Currency*, London, 1825; *Views on the Currency*, London, 1828; and *An Essay on the General Principles and Present Practice of Banking in England and Scotland*, 5th ed.; London, 1826.

<sup>16</sup> Act of 1826, 7 G IV, C. 46.



ideas of the writers we have been discussing, Liverpool's speech,<sup>17</sup> introducing the Government's measures of 1826, contained little reference to any general principles of currency regulation, though in passing he gave assent to the now well-recognized doctrine that the currency should be regulated by the foreign exchanges. In stating the ideas behind the Government's proposed reforms, he said that protection for the poorer classes was a sufficient reason for abolishing the small notes, and that the strength and solidity of the system would be improved by the establishment of joint-stock banks. In short, the objective was mainly that of ensuring the solvency of the banks. It is very doubtful whether any member of the Government even saw the desirability of broad plans for regulating the quantity of the currency such as had been suggested by Drummond, Joplin, and Page. The tendency of Government spokesmen in 1826 was to exonerate the Bank of England from blame and to concentrate their attacks upon the country banks.

The development of views described above gradually came to influence the ideas of a majority of the directors of the Bank of England.<sup>18</sup> In 1832, when giving testimony before the Parliamentary Committee on the Bank of England Charter, the directors revealed that they had adopted a new principle of management closely related to the proposals later made by the Currency School. This plan, which was intended to secure the regulation of the currency by the exchanges, had been adopted during 1827.<sup>19</sup> Horsley Palmer, describing the plan,<sup>20</sup> said that the directors aimed at keeping the securities held by the Bank at an unvarying amount. The term "securities" was used to cover all the earning assets of the Bank, except those which represented its invested capital. The object was to make the Bank's total liabilities (deposits plus notes) vary one for one with the fluctuations in the metallic reserves. Palmer stated that by this means "the circulation of the country, so far as the same may depend upon the Bank (was being) regulated by the action of the foreign exchanges."<sup>21</sup> As a starting point, it was decided that one-third of the liabilities should be backed by bullion when the exchanges were at par. When the exchanges were at par, Palmer said, the "currency" was "full." Unfavorable exchanges indicated that the quantity of the currency was too large and favorable exchanges that it was too small.

<sup>17</sup> Hansard, *Parliamentary Debates* (2d Series), XIV, 450 ff.

<sup>18</sup> In connection with the change of views at the Bank there may be mentioned a little known writing of Horsley Palmer, Governor of the Bank in 1832. Privately circulated in 1827, this was a plan for the concentration of the note issue in the hands of a single issuing body, preferably the Bank of England. One aim of the plan was to ensure regulation of the currency by the foreign exchanges. This plan under the title "Bank of England Circular" appeared in *The Morning Chronicle*, May 30, 1827. It was published anonymously, and one of the Bank directors, Manning, denied in Parliament that the directors knew anything of it. However, its authorship is confidently attributed to Horsley Palmer by James Taylor, *A Letter to His Grace the Duke of Wellington on the Currency*, London, 1830, Postscript. The Plan was reproduced for vitriolic comment in *Cobbett's Weekly Register*, Vol. LXII, London, 1827, cols. 581-588.

<sup>19</sup> *Report on the Bank of England Charter*, 1832, evidence of William Ward, qs. 2074-2080.

<sup>20</sup> *Report on the Bank of England Charter*, 1832, q. 72.

<sup>21</sup> *Ibid.*



The main difference between this plan (which in practice was realized only very imperfectly) and that of the Currency School was that according to the former the Bank's total liabilities (including *deposits*) were to be regulated by the fluctuations in the metallic reserves, whereas according to the Currency School plan only the *notes* were to be so regulated. There is some reason for concluding that the Bank plan involved a confusion as to the nature of deposits—an assumption that deposits were paper money.

## IV

The 1836 crisis produced the first crop of Currency School writings. After the crisis of 1839 many more appeared. Lord Overstone,<sup>22</sup> Torrens,<sup>23</sup> Norman,<sup>24</sup> Clay,<sup>25</sup> Samson Ricardo,<sup>26</sup> and Hubbard<sup>27</sup> were the most important representatives of the Currency School who with a remarkable uniformity of ideas put forward the doctrine that the note issues would be correctly regulated if they were made to fluctuate in volume exactly as a purely metallic currency would have done. They contended that under the currency system of their time banks could, and frequently did, issue notes to an amount greater than would have been the volume of a currency consisting only of specie. This the Currency School termed an "overissue" of the note circulation. Such an overissue might cause a rise of prices above their proper level and a drain of gold abroad, they said, and furthermore the banks might, and often did, continue to issue notes to excess while gold was leaving the country, and hence no check would be imposed

<sup>22</sup> Two pamphlets containing typical statements of Overstone's views were his *Reflections Suggested by a Perusal of Mr. J. Horsley Palmer's Pamphlet* (1837), and *Remarks on the Management of the Circulation* (1840). These and other writings by Overstone expressing similar views are included in *Tracts and Other Publications on Metallic and Paper Currency*, ed. J. R. McCulloch, London, 1857.

<sup>23</sup> Robert Torrens, *A Letter to the Rt. Hon. Lord Viscount Melbourne on the Causes of the Recent Derangement on the Money Market*, 2d ed.; London, 1837; *A Letter to Thomas Tooke*, London, 1840; and *An Inquiry into the Renewal of the Charter of the Bank of England*, London, 1844.

<sup>24</sup> G. W. Norman, *Remarks Upon . . . Currency and Banking*, London, 1838; and *Letter to Charles Wood on Money*, London, 1841.

<sup>25</sup> Sir William Clay, *Speech of William Clay, Esq. M.P., on the Establishment of Joint-Stock Banks, to Which are Added Reflections*, London, 1836; and *Remarks on the Expediency of Restricting the Issue of Promissory Notes to a Single Issuing Body*, London, 1844.

<sup>26</sup> *Observations on the Recent Pamphlet of J. Horsley Palmer, Esq.*, London, 1837; and *A National Bank*, London, 1838.

<sup>27</sup> John Gellibrand Hubbard (Lord Addington), *The Currency and the Country*, London, 1843.

Other writers of this period having views close to if not always identical with those of the Currency School were: J. R. McCulloch, "The Bank of England and the Country Banks," *Edinburgh Review*, LXV (April-July, 1837), and "Supplemental Notes and Dissertations" in his edition of Adam Smith, *The Wealth of Nations*, Edinburgh, 1848, Note IX, "Money"; John Hall, *A Letter to Thomas Spring Rice. . . . Containing a New Principle of Currency*, London, 1837; William Ward, *On Monetary Derangements*, London, 1840; Mountfort Longfield, "Banking and Currency," *Dublin University Magazine* XV (1840), XVI (1840).



on the outflow. They pointed out that under a purely metallic currency an export of gold would automatically reduce the volume of the internal currency and hence raise its value. The rise in its value or, in other words, the fall of the general price level, would then impose a check on the export of gold by discouraging imports of commodities and encouraging exports. If a paper currency were made to operate on this principle, the Currency School argued, an early and salutary check would be placed upon drains of gold from the Bank of England, and hence the convertibility of its notes would be assured. They contended also that if gold drains were arrested in their early stages by measures gradually instead of suddenly applied and before prices had risen very much, the severity of the commercial crises would be much reduced.

Their plan was that the Bank of England should be divided into two departments.<sup>28</sup> There should be the Banking Department which would receive deposits and make loans and the Issue Department which should have no function other than that of issuing notes in exchange for gold and paying out gold on demand for its notes. An important feature of the provision applying to the Issue Department was the fixed fiduciary issue. A certain fixed amount of notes was to be backed by Government securities; the amount was set considerably below the actual circulation so that there would always be a safe margin backed by gold. The object of this provision was to retain the economies of a paper circulation, while the provision that the variable part of the issue should be backed by gold would, according to the Currency School, secure the regulation of the whole of the note issue on the principles of a purely metallic currency.

As far as the note issues of other banks in the country were concerned, the Currency School hoped for their eventual abolition, and the Act of 1844 made provision accordingly. No new banks of issue were to be established, and those which were already issuing were to be encouraged to give up the right of issue. If they did so they were to receive a composition fee of one per cent per annum of the amount of Bank of England notes which they would circulate in place of their own. Those who continued to issue were limited to an amount equal to the average circulation of the three months period immediately preceding the passing of the Act. The view of most members of the Currency School was that while the Bank of England did have some power of control over country issues through the balance of payment mechanism between town and country, this power of control was not rapid enough in its operation to secure efficient regulation of provincial note issues.

The main ideas of the Currency School, as described above, are well known. One important part of their views, their discussion of bank deposits, has, however, been relatively neglected. An indication of what is to be found in the

<sup>28</sup> This idea dated back to Ricardo, "Plan for the Establishment of a National Bank," 1824. As far as the Currency School was concerned it was Overstone who apparently revived the idea in discussion at the Political Economy Club (see Torrens, *The Principles and Practical Operation of Sir Robert Peel's Act*, (3d ed., London, 1858) Preface to the Second Edition, p. X. Torrens, himself, is often credited with being the originator of the plan as he was the first of the Currency School to publish it in his *Letter to Lord Melbourne*, 1837.



literature of the Currency School is therefore in order. While the Currency School directed their reforms at the note issue alone, and while in the Act of 1844 there were no provisions regarding deposits, it is not right to conclude that these writers did not regard deposits as currency,<sup>29</sup> or denied that deposits had any influence on prices. Many of these writers had remarkably well developed views on the subject of deposits. A study of their statements on this matter shows that all shades of opinion were expressed. At the one extreme, it is true, there were a few writers like Samson Ricardo<sup>30</sup> and Hubbard<sup>31</sup> who either ignored or denied the view that deposits were money and could, like notes, be created by the banks; at the other, however, were Torrens<sup>32</sup> and Sir William Clay<sup>33</sup> who recognized the importance of deposits in these respects and attempted to modify the traditional theory accordingly. The two latter writers are representative of those who held the view that deposits constituted a superstructure of credit currency dependent on a base of notes and gold. They therefore concluded that it was sufficient to provide for the statutory regulation of notes alone since the latter would in turn automatically regulate the quantity of deposits. Overstone, while not unwilling to give his assent to some of the more advanced propositions concerning deposits—such as, that they represented a form of “auxiliary” currency—nevertheless did not see the necessity for making much use of the “dependence theory” to defend his position.<sup>34</sup> At bottom his attitude seems to have amounted to a blind conviction that a steady contraction of notes as gold left the country must produce a steady increase in the value of money irrespective of all questions concerning the behavior of deposits. In this attitude he was followed by the sponsors of the Currency Principle in Parliament, particularly Peel and Sir Charles Wood.

The views of the Currency School received considerable support from the business community, most notably from the Manchester Chamber of Commerce which issued a report<sup>35</sup> condemning the policy of the Bank of England in regard

<sup>29</sup> As, for instance, is suggested by Professor Gregory. Cf. *Select Statutes*, Introduction, p. xxiii.

<sup>30</sup> Cf. *Observations on the Pamphlet of J. Horsley Palmer*, pp. 19–20, 28–30; and *A National Bank*, p. 11.

<sup>31</sup> Cf. *The Currency and the Country*, p. 13.

<sup>32</sup> Cf. *A Letter to Lord Melbourne*, 5–19. Torrens was indebted to James Pennington, in a paper communicated to Thomas Tooke, published as an appendix to Thomas Tooke, *Letter to Lord Grenville* (London, 1829) and a paper communicated to Torrens, published as Appendix II to Torrens, *A Letter to Lord Melbourne*, pp. 76–80. In 1829 also, N. W. Senior presented a similar theory in *Three Lectures on the Value of Money*, (London School of Economics, No. 4 of the Reprints of Scarce Tracts, 1931).

<sup>33</sup> *Remarks on Restricting the Issue of Promissory Notes*, pp. 16–18. Others, at this time, took the simple view that deposits were money because they represented notes placed in the bank. Cf. evidence of Richard Page, J. B. Smith, and Richard Cobden before the Committee of 1840.

<sup>34</sup> For Overstone's views on deposits see particularly, “Second Letter to J. B. Smith (1840), *Tracts*, p. 201; and his evidence before the Committee of 1840, qs. 2663–2676, 2807.

<sup>35</sup> J. B. Smith, *Report . . . on the Effects of the Administration of the Bank of England*, Manchester Chamber of Commerce, 1840.

to its note issues as the main cause of the speculative booms and crises. In Parliament the movement for reform began with the Parliamentary enquiry of 1840–1841 into “the effects produced on the circulation of the country by the various banking establishments issuing notes payable on demand.”<sup>36</sup> By the beginning of 1844 the demand for currency reform of the kind advocated by the Currency School was so widespread that Peel was able to present a bill to Parliament, which embodied the Currency School plan and which passed through Parliament with virtually no opposition, becoming law on July 19, 1844.<sup>37</sup>

## V

The principal writers of the Banking School—Tooke, Fullarton, and Wilson—did not begin to attack the Currency School theories until shortly before the Peel Act was passed, which is perhaps one reason why the Act passed with so little opposition. Gilbart<sup>38</sup> and Bailey,<sup>39</sup> in the late thirties, had largely anticipated the Banking School position in their defense of joint-stock banks. Again in 1841, Gilbart attacked the Currency School proposals, arguing that the currency should be regulated by trade and not by the foreign exchanges.<sup>40</sup> Tooke was, however, the only one of the three outstanding Banking School writers to attack the Currency School measures before they became law on July 19, 1844.<sup>41</sup>

Although Tooke had been writing on the subject of the currency for twenty years, he had not always been an opponent of the type of views adopted by the Currency School. At the outset his position was similar to those of Ricardo and his followers. It was only gradually that his views had changed their character. After the 1837 crisis he had differed only slightly from the Currency School in his criticism of the Bank of England. It was not until after the crisis of 1839 that he definitely began to question the value of Currency School proposals; and it was only with the publication of his *An Inquiry into the Currency Principle* in 1844 that he made a complete break with the main ideas of the Currency School and became their vigorous opponent. Tooke's pamphlet was followed in the same year by John Fullarton's *On the Regulation of Currencies*.<sup>42</sup> Then in 1845 James Wilson wrote a series of articles in the *Economist*<sup>43</sup> attacking the Currency School in the same vein.

While much of the reasoning in these writings does not hold up under close

<sup>36</sup> *Reports. . . on Banks of Issue* (1840); Vol. V (January–June, 1841).

<sup>37</sup> 7 and 1 Victoria, C. 32, *An Act to Regulate the Issue of Bank Notes and for Giving to the Governor and Company of the Bank of England Certain Privileges for a Limited Period*. See T. E. Gregory, *Select Statutes*, I, 129 ff.

<sup>38</sup> J. W. Gilbart, *The History of Banking in America; . . . and a Review of the Causes of the Recent Pressure in the Money Market*, London, 1837.

<sup>39</sup> Samuel Bailey, *Money and Its Vicissitudes in Value*, London, 1837.

<sup>40</sup> In *Currency and Banking*, London, 1841; and “The Currency: Banking,” *Westminster Review*, XXXV (1841), 89–131.

<sup>41</sup> In *A History of Prices*, Vol. III, chap. iv; and in *An Inquiry into the Currency Principle*, London, 1844. An excellent summary of Tooke's views is contained in T. E. Gregory, *An Introduction to Tooke and New March's A History of Prices*.

<sup>42</sup> 2d ed.; London, 1845.

<sup>43</sup> Collected and published under the title, *Capital, Currency and Banking*, London, 1847.



inspection, it was presented in a polished style and accompanied by discussion which showed a wide knowledge of commercial and financial matters. Basing their views on those of the practical banker, the Banking School objected to what they regarded as unnecessary interference with free trade in banking. They rejected most of the theories of the Currency School and argued that, in the main, the convertibility of the currency, as proclaimed in the Act of 1819, together with the forces of self-interest, were sufficient to maintain an orderly monetary system.

The views of the Banking School can be conveniently divided into three parts—their doctrines on money and prices, their views on gold flows under a purely metallic currency, and their proposals regarding Bank of England policy.

These writers rejected the distinction which the Currency School drew between notes and other forms of non-metallic money. They denied that bank notes had a peculiar right to be classed as money. They asserted that bank notes were only one form of "paper credit"; checks and bills of exchange were the two other important forms, and whatever properties were attributed to notes must also be ascribed to these.<sup>44</sup> They denied also that banks had any "direct" control over the amount of notes or coin in circulation. A banker had direct control only over his advances. Only a very small part, if any, of his advances consisted of notes or coin, and what part this was could not be determined by the banker.<sup>45</sup> At several points, however, these writers admitted that banks had the power indirectly to influence the volume of note issues. In Tooke's words, for example, bankers might "curtail or call in their advances and so diminish their engagements, and eventually render a smaller amount of circulation necessary. . . ."<sup>46</sup> The Banking School, however, failed completely to see how much this admission weakened their case against the Currency School.

The Banking School went further. They not only denied that general prices could be influenced by bankers' policies in regard to their note issues; they also flatly rejected the view that changes in the whole volume of the circulating medium would cause changes in the general price level. The arguments of these writers on this subject were by no means clearly stated. They varied from one writer to another and from time to time.

Tooke offered a price theory in two parts. In the long run, he said, general prices (retail prices which governed wholesale prices) were governed by incomes, not by the total quantity of money in circulation.<sup>47</sup> (This was a theory also

<sup>44</sup> Tooke, *The Currency Principle*, pp. 17-33; Fullarton, *Regulation of Currencies* pp. 30-31; Wilson, *Capital, Currency and Banking*, p. 41.

<sup>45</sup> Tooke, *Op. cit.*, pp. 33-54; Wilson, *Op. cit.*, pp. 10-16.

<sup>46</sup> Tooke, *Op. cit.*, p. 38.

<sup>47</sup> *Ibid.*, pp. 71-72. In view of the important later developments in the income approach to price theory (cf. Arthur W. Marget, *The Theory of Prices*, 1938, ch. xii) it may be worthwhile to note that income theories were also presented by two other writers of the period, but these two were on the Currency School side of the controversy. J. A. Yates (*Op. cit.*, pp. 111, 1367) was one of these and Torrens the other (See his *The Principles and Practical Operation of Peel's Act*, pp. iii ff). Both these writers used the income theory to support the argument that since currency of small denominations was used to circulate income, such currency, in particular, should be regulated by the Currency Principle.

presented by John Stuart Mill.<sup>48</sup>) In the short run wholesale prices might fluctuate independently of real consumer demand as a result primarily of miscalculation arising out of undue optimism or pessimism on the part of the business and banking community—the exaggerated expectations of business men being supported by the willingness of bankers to lend on inadequate security, in the case of a business boom, for example.<sup>49</sup> This view of prices constituted Tooke's explanation of the recurrent business fluctuations and was subscribed to more or less by others of the Banking School. Here and at other points in Banking School theory the profit anticipations of the business community played a very important role.<sup>50</sup> It was these rather than the volume of available purchasing power which regulated spending. The volume of available purchasing power was, in general, much larger than the actual requirements of the public, in the view of these writers. In reading the literature of the recent revolt against the quantity of money approach to problems of general prices one is struck by the degree to which the Banking School, with all its haziness and apparent naiveté, anticipated many of the threads of thought in modern business cycle analysis.

Tooke and Fullarton and others also contrasted an inconvertible with a convertible currency.<sup>51</sup> They suggested that the Currency School had confused the operation of the two types of currency. The Banking School said that a government could issue inconvertible paper at will and hence could influence general prices. A convertible currency, however, was not and could not be regulated by the issuers (the banks); it was and must be regulated by the demand of the public. The argument continued that a currency which was regulated by demand could never be overissued because, if the public had a free choice as to the amount of currency they would circulate, they would never put so much into circulation as to cause a rise of prices. And they *had* a free choice because a convertible currency was issued through bankers' loans, any redundancy being prevented by "the regular reflux of notes advanced on loan."<sup>52</sup> "It is the *reflux*," Fullarton said, "that is the great regulating principle of the internal currency."<sup>53</sup> As with many of his doctrines, Fullarton failed to describe precisely the operation of the "principle of reflux." He merely described the repayment of loans as the channel through which the public returned to the banks any currency for which they had no further "use." Tooke said that "if the loans or discounts

<sup>48</sup> In "An Inquiry into the Currency Principle, by Thomas Tooke; and an Inquiry into the Renewal of the Charter of the Bank of England, . . . by Robert Torrens," *Westminster Review*, XLI (June, 1844) 579–98.

<sup>49</sup> *The Currency Principle*, p. 85.

<sup>50</sup> Cf. *ibid.*, pp. 73, 76, 79. On p. 79, Tooke says, for example, "The truth is that the power of purchase by persons having capital and credit is much beyond anything that those who are unacquainted practically with the speculative markets have any idea of. The error is in supposing the disposition or will to be co-extensive with the power. The limit to the motive for the exercise of the power is in the prospect of resale with profit." Cf. also Fullarton, *Op. cit.*, p. 73, and J. S. Mill, "An Inquiry into the Currency Principle." *Westminster Review*, XLI, p. 590.

<sup>51</sup> *Ibid.*, pp. 69–71; and Fullarton, *op. cit.*, pp. 58, 130.

<sup>52</sup> *Op. cit.*, p. ix.

<sup>53</sup> *Ibid.*, p. 68.



are advanced on proper securities, for short periods, the reflux of the notes, if any have been issued, will be equal to the efflux, leaving the circulation unaltered."<sup>54</sup> He failed to see, however, that as long as a bank could find borrowers and had sufficient reserves it could increase its note issues indefinitely by granting more and more loans. The fact that there would be a stream of maturing loans would not prevent an increase in its outstanding note issues from taking place.

These writers did not succeed in showing that there was anything inherent in the nature of a convertible currency which prevented overissue. Even if the argument that notes issued on loan could not be issued to excess is accepted, there remains the point that convertible paper might be paid out by a government and thus take on the character of a forced issue. Fullarton actually admitted at one point that it was not the convertibility as such but the "reflux" which protected the currency against overissue.<sup>55</sup> He also intimated that an inconvertible currency might be safely regulated by loan and reflux.<sup>56</sup>

It seems to have been a fundamental underlying belief of Tooke, Fullarton, and Wilson that where the public obtained its supplies of circulating medium by borrowing from banks, only that amount would be circulated which was necessary to support an independently given level of prices and a given volume of transactions. The Banking School seem to have thought that this conclusion followed from the proposition that the public could have no motive for desiring to possess more currency than that required for the purchases of all individuals at current prices. Perhaps these writers were misled by taking into account the effects of the actions of only a single individual. The fact that each member of a business community might borrow from a bank only that amount of money which would suffice to cover his intended purchases at current prices, did not prevent a general rise of prices from occurring as the result of the expenditure of borrowings in the aggregate.

The views of the Banking School on the rate of interest were various. At one point Tooke denied that a lowering of the rate of interest would lead to a rise of prices through encouraging speculation.<sup>57</sup> He said that the profit contemplated in speculative buying was usually so large as to make the rate of interest a matter of little consideration. Furthermore, he said that a fall of the interest rate through lowering costs of production would cause a general fall of prices.<sup>58</sup> Elsewhere, however, Tooke declared that low rates of interest were very important in tending to generate speculation. He said that, generally speaking, supposing the existence of motives to speculation there was one condition which seemed most highly favorable, if not essential, to its widespread development and that was a low rate of interest of some continuance.<sup>59</sup> Fullarton's idea was that the

<sup>54</sup> *A History of Prices*, IV, 194.

<sup>55</sup> *Op. cit.*, p. 68.

<sup>56</sup> *Ibid.*

<sup>57</sup> *The Currency Principle*, p. 82.

<sup>58</sup> *Ibid.*, p. 81.

<sup>59</sup> *A History of Prices*, IV, 271.

recurrent booms were caused largely by periodic over-accumulations of capital which depressed the rate of return on investments and impelled investors to seek larger yields in risky and speculative undertakings.<sup>60</sup>

How was it possible for the Banking School to admit, as they did at various points, that banks could play an important role in encouraging a cyclical upswing of prices through their loan policies and at the same time deny that the supply of money could have an important effect upon prices? The answer would seem to lie in the distinction which they continually drew between capital and credit on the one hand and the circulating medium on the other.<sup>61</sup> Banks loaned their capital and credit; these were the sources of purchasing power and hence were causal factors in the determination of prices. The amount of the circulating medium was merely a resultant of the other forces at work. The primary causal factor was business men's anticipations aided and abetted by the secondary factor, the availability of capital and credit.

On the subject of gold flows, the Banking School began with the same premise as the Currency School; both groups held that a paper currency ought to conform to the principles of a purely metallic currency. The difference between the two Schools began with the question as to whether or not the mixed currency of their day actually did conform to the laws of a metallic currency. In opposition to the Currency School the Banking School answered this question in the affirmative. The latter group argues that under a purely metallic currency large hoards of the precious metals would exist, and the incidence of gold imports and exports would be mainly on such hoards and not on the actual circulation, as claimed by the Currency School. A net outflow of gold, they said, would be drawn from these hoards and hence would not affect the internal circulation. With regard to an inflow of gold from abroad, they said that the mere occurrence of this would not cause an increase in circulation or induce people to spend more. They argued, as indicated above, that it was other factors, such as changes in profit anticipations, the yield on investments, and money incomes, which were responsible for changes in general prices; an increase in the circulation could only take place in response to the operation of these factors. If the specie was not "required" in circulation, it would remain dormant in the hoards.

Tooke described two types of hoards. The first of these was what he referred to as the "floating stocks" of gold seeking a market,<sup>62</sup> and the second (also noted by Wilson<sup>63</sup>) was bank reserves.<sup>64</sup> There were, he said, in countries commercially developed, whether having purely metallic currencies or mixed ones, large floating stocks of gold not yet appropriated to any particular use but "seeking a market." From these stocks might be drawn large amounts for import or export, and hence the internal currency would be left unaffected.<sup>65</sup> As to who

<sup>60</sup> *Op. cit.*, pp. 169-71.

<sup>61</sup> Cf. Tooke, *The Currency Principle*, pp. 35, 73, 79, 85; Fullarton, *op. cit.*, pp. 83-84, 194, 195-196.

<sup>62</sup> *The Currency Principle*, p. 9.

<sup>63</sup> *Op. cit.*, pp. 16-21.

<sup>64</sup> *Op. cit.*, pp. 13-14.

<sup>65</sup> *The Currency Principle*, p. 9.



would find it in his interest to hold such stocks of gold or why, Tooke had little to say.

As regards Tooke's second type of hoards, bank reserves, it has to be admitted that, unless 100 per cent metallic reserves were kept, gold flows might occur without affecting correspondingly the total volume of means of payment (currency plus deposits). The Currency School could still argue, however, that under this type of "purely metallic currency" only the *deposits* would be free to vary independently of gold stocks, while before 1844 *notes* as well as deposits could vary freely.

Fullarton had something different in mind when he spoke of hoards under a metallic currency.<sup>66</sup> He imagined that no banks would exist and that for that very reason hoards would be maintained by private persons and money dealers. He said that it was the very essence of a metallic system that the hoards should be adequate for two objects, that they should supply the bullion demanded for exportation and should keep up the home circulation to its legitimate complement. For such purposes men would either keep a store of specie themselves or else keep the means of borrowing their needs from others. On the basis of this view, Fullarton argued that if self-interest provided shock-absorbing hoards under a metallic system, and if the metallic model was to be respected, bank reserves under a mixed currency ought to preserve this shock-absorbing quality.<sup>67</sup>

To answer Fullarton's argument here, it would seem at first glance that the Currency School either had to deny his assertions as to the existence of hoards under a metallic currency, or else, to abandon the metallic model justification and rest their case on other considerations. However, Fullarton himself provided a weak point at which his argument might be attacked. He did this when describing how it was that hoards under a purely metallic currency would come to be used for export. An export of gold represented an export of capital, he said, and created therefore an additional demand for capital. This raised the rate of interest and drew the gold from the hoards, he argued.<sup>68</sup> But if this argument is correct and the gold would only come out of hoards if the rate of interest rose, then the question at once comes up as to whether this rise in the interest rate would not at the same time tend to depress business activity, to reduce the amount of money in circulation, and to lower prices.

The main constructive proposal made by the Banking School was that the Bank of England should maintain a larger average reserve. The chief proponents of this view were Tooke and Fullarton. We do, indeed, find Wilson—later, in 1847—advocating the substitution of one and two pound notes for coin in order to increase the stock of bullion. But his main reason for this proposal seems to have been somewhat different in character from that of Tooke and Fullarton. He argued that the country was suffering from a shortage of floating capital and that this was a way to obtain more capital.<sup>69</sup> John Stuart Mill,

<sup>66</sup> *Op. cit.*, p. 142.

<sup>67</sup> *Ibid.*

<sup>68</sup> *Ibid.*, pp. 140–41.

<sup>69</sup> *Op. cit.*, pp. 241–49.

while he thought that the proposal to keep a larger average reserve was an improvement on the Act of 1844, was of the opinion that it would be impossible to enforce such a rule by law; it could, he thought, only be enforced by public opinion.<sup>70</sup>

Tooke and Fullarton proposed that the Bank of England should provide itself with enough gold so that a decline of its reserves would not immediately necessitate the adoption of restrictive measures. They held that this would reduce the recurrent shocks to business. Their attitude on this question was greatly reinforced by their belief that most foreign gold flows were of a type which would end spontaneously and hence without the necessity for corrective action on the part of the Bank of England.

Tooke's plan was that the Bank should, during the next inflow of gold, maintain its discount rate above the market rate until its reserves had increased to fifteen million pounds. Then, starting with fifteen millions, the Bank might allow the next efflux of gold to draw down its reserves to ten millions before taking any action to stop the drain. If the drain did not cease at that point it might reasonably be supposed that it was due to deep-seated causes and measures should be taken to check it. Such measures would in all probability, he said, stop the drain before the reserves had fallen to five millions.<sup>71</sup> Tooke believed that the way to arrest a drain of gold abroad was to raise or lower the Bank rate in relation to the market rate. He said that the rationale of such a measure was that it rendered disposable capital in the one case scarce, and in the other, abundant; forcing it from foreign countries in the former case and to them in the latter case.<sup>72</sup>

Fullarton enumerated what he considered to be the most common causes of gold drains. He argued that it was impossible to check some of these by action on the part of the Bank of England. Such was the case in respect to demands from abroad for coinage, for hoarding, for replenishing the treasuries of kings, the reserves of banks and military chests of armies.<sup>73</sup> As he pointed out, these demands could only be satisfied with gold and nothing could be substituted for it. He did not observe that while this was true, an influx of gold to take the place of that exported might be brought about by action designed to affect the exchanges. In another category were drains arising from large imports of foreign grain, and those connected with the support of armies operating abroad. It was for emergencies such as these, he held, that metallic reserves were maintained, and it was in the national interest that they should be used at such times.<sup>74</sup> There were, however, two other important types of drains concerning which he

<sup>70</sup> *Report from the Select Committee on Bank Acts, Parliamentary Papers*, Vol. X (1857), Part I, qs. 2012-2019.

<sup>71</sup> *The Currency Principle*, pp. 115-17. Cf. also Homer Stansfeld, *Comments on the Currency Fallacies of Lord Overstone*, London, n.d., p. 5; and *A Few Reasons for the Immediate Reconsideration of the Bank Charter Act of 1844*, London, 1855, p. 7; and Robert Cockburn, *Remarks on Prevailing Errors Respecting Currency and Banking*, London, 1844, pp. 57 ff.

<sup>72</sup> *Ibid.*, p. 103.

<sup>73</sup> *Op. cit.*, p. 153.

<sup>74</sup> *Ibid.*, pp. 156-60.



admitted that action on the exchanges might be desirable.<sup>75</sup> One was the case of an export due to a speculative boom. In this case he thought that the Bank did not acquire sufficient control over the market to affect prices until the "market was in the Bank." He said that usually by that time the tide was already at the turn and restrictive measures could only have violent effects, intensifying the inevitable reaction. The other case was that of a drain due to "excessive" foreign investment. In this connection, while he agreed with Tooke that the only method by which the Bank could check a flow of capital abroad was to raise its discount rate, he was very skeptical as to the efficacy of such action.<sup>76</sup> Furthermore, he thought that natural forces would inevitably arise to remove the cause of this type of drain.

As a result of the fact that he placed less emphasis than Tooke on the possibility of pumping in and forcing out bullion, Fullarton placed more on the necessity of maintaining large reserves.<sup>77</sup> He described several ways in which the stock of gold might be economized. He advocated a seigniorage, and he proposed that the Bank should hold a considerable amount of silver in a form suitable for export. The small note circulation might be reintroduced, he thought; and, finally, he favored the idea that the Bank should hold foreign securities to be applied to correcting the exchanges where necessary.

As has been noted above the opposition of the Banking School to Currency School reforms did not prove sufficiently formidable to stem the rising tide which culminated in the Peel Act. The passage of this Act by no means ended the controversy, however. In the years after 1844 the reform measures were put to severe test by turbulent events, and fresh outbursts of defense and criticism were evoked. It is intended in another and concluding paper to analyze the events and discussion which followed the Bank Act, with a view to coming to some general conclusions as to the relative merits of the two opposing points of view.

<sup>75</sup> *Ibid.*, pp. 161 ff.

<sup>76</sup> *Ibid.*, pp. 149-50. Cf. also Robert Somers, *The Errors of the Banking Acts of 1844-45*, 1857, p. 77.

<sup>77</sup> *Ibid.*, pp. 229-39.





## THE CURRENCY-BANKING CONTROVERSY: II

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In a preceding article an account was given of the opposing views of the Currency and Banking Schools against the background of events and ideas which gave rise to them. The analysis was carried up to the passage of Peel's Act of 1844. It is proposed in the present paper to conclude with a discussion of the working of the Act and the continued controversy regarding it. Particular attention is given to the first years of the Act's operation, 1845-1857, a period which included two major economic crises.

### I

Peel's Bank Act came into operation on August 31, 1844. At that time the reserve position of the Bank was most favorable. During the years 1840 to 1844 there had occurred a large influx of gold which had carried the Bank reserves to fourteen million pounds in August, 1844—an unprecedentedly high level. This allowed for the Banking Department reserve a much larger amount (eight millions) than had generally been anticipated. It meant a reserve ratio of over 61 per cent (of notes to deposits) as against the 33½ per cent imagined by Torrens. The total bullion reserve of the Bank increased still further in 1845 and 1846, finally reaching a level of sixteen millions.

In the two years following the passage of the Act, with the first major railway boom in progress, business was prosperous, and the Government congratulated itself on the successful working of the Act. In 1847, however, the process of industrial expansion was checked by a serious commercial crisis. During the first three months of 1847 the Bank's metallic reserves declined from fifteen to ten millions, nearly the whole burden falling on the reserve of the Banking Department. The latter fell from eight to three millions. The Bank was greatly blamed for its tardiness in raising its discount rate during this drain. It was not until April, when the Bank rate was raised to 5 per cent, that it reached the market rate, and by this time Banking reserve had already fallen to three millions. After recovering somewhat, the reserve began to decline again later in the year. The Bank rate was then raised to 5½ per cent. The reserves continued to fall, however, at an increasing rate, the Banking reserve declining from four millions to one million during October. This second drain appears to have been mainly caused by an internal demand for gold. The question therefore arose as to whether it would not be better for the Bank to make liberal advances rather than to restrict loans. A liberal policy had worked in the crisis of 1825. The Bank, however, continued its restrictive policy, no doubt out of fear that to lend freely would have resulted in a complete disappearance of the already very much reduced reserve in the Banking Department.<sup>1</sup>

<sup>1</sup> For this fear there was some justification. In the crisis of 1857 when the Act of 1844 was suspended the increased issuance of notes to the public was larger than the amount of

It was under these circumstances and in the light of the fact that the Issue Department had a reserve of seven millions, that the Government at last yielded to pressure and issued the famous Treasury Letter suspending the Act of 1844. The Letter apparently produced immediate relief to such an extent that there was no call for an expansion of notes by the Bank, and hence there was no infringement of the Act.

This period of economic expansion was interrupted in 1854 by the outbreak of the Crimean War which necessitated a large outflow of funds to support armies abroad. In the fall of 1856 the Bank rate rose as high as 7 per cent. This pressure passed without complications and the Bank apparently felt well pleased with its policy. In the latter part of 1857, however, the railway boom which had been in progress in the United States came to an abrupt conclusion. All the banks of the larger centres in that country suspended payments. Many English and Scottish banks which were closely connected with the American trade failed, and the repercussions soon became widespread. London bankers called their loans to discount houses, and the bill brokers thereupon had recourse to the Bank of England. The Bank had already had its reserve reduced by war expenditures and now, although the foreign drain had ceased, an increasingly serious internal drain arose. The Bank found itself in much the same position as in 1847, that is of feeling the necessity of adopting a liberal policy but of fearing to exhaust the reserves of the Banking Department. By successive steps the discount rate was raised until on November 9, 1857, it reached 10 per cent. On November 12, when the Banking reserve had fallen to half a million pounds, a Government Letter authorizing the suspension of the Act was issued. This time the demand for credits was not sufficiently allayed by the Government Letter to prevent an infringement of the Act. The Bank as a whole issued close to one million pounds in notes beyond what was legal under the Act.<sup>2</sup>

## II

These events gave rise to much discussion. Most notable were the investigations of three Parliamentary Committees<sup>3</sup> and the evidence given by Currency and Banking School writers before these Committees.

The Committee of the House of Lords of 1847-1848 argued in its Report that the main defect of the Act of 1844 was that under its provisions internal drains had to be treated in the same way as foreign drains. According to the Report,

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notes in the Banking Department reserve just before the suspension of the Act. In 1825, also, although a liberal policy had saved the Bank's *gold* it had not prevented an extraordinary issuance of *notes*.

<sup>2</sup> On the events of the crisis related here see Great Britain, House of Commons *Report on the Bank Acts, Parl. Papers*, Vol. X (1857), pp. viii-xii.

<sup>3</sup> Great Britain, House of Commons, *First and Second Reports on Commercial Distress, Parl. Papers*, Vol. VIII (1847-1848), Parts I and II; House of Lords, *Report from the Secret Committee . . . Appointed to Enquire into the Causes of the Distress . . . , Parl. Papers*, Vol. VIII (1847-1848), Part III; House of Commons, *Report on the Bank Acts, Parl. Papers*, Vol. X (1857, 2d Session), Parts I and II; and Vol. V (1857-1858).



a liberal, not a restrictive, policy ought to be followed by the Bank of England during crises as long as the foreign exchanges were favorable, as in the second drain of 1847 when the exchanges had been favorable, and the drain of gold had been mainly due to internal demand. Too little attention, it was said, was paid to the velocity of circulation as a factor influencing prices. It was pointed out that a domestic demand for gold, or for accommodation in any form, occurring at the height of a crisis clearly arose out of a desire to hold cash rather than to increase the active circulation. There was no danger therefore that it would lead to a rise of prices and further drain on the Bank. The cause of the drain was mainly loss of confidence, and the appropriate corrective measure was one which would restore confidence. The Report concluded by recommending that the Bank Act should be amended to provide for a discretionary relaxing power to be exercised only if the foreign exchanges were favorable.<sup>4</sup>

The Currency School and important directors of the Bank vigorously opposed the proposal to include a relaxing clause in the Act of 1844.<sup>5</sup> They objected, first, that a foreign drain would not be checked if relaxation of restrictive measures were anticipated by the public; second, that a relaxing clause would reintroduce into the management of the currency the factor of discretionary action which had proved so dangerous before 1844; and, third, that a departure from the principles of a purely metallic currency would be involved. To support the position of the Lords' Committee there was a long history of authoritative opinion and of actual events. The question had been debated as early as the crisis of 1793 when an internal drain on the Bank had been relieved by an emergency expansion of Government credit. Commenting on these events, the Bullion Report had contained a decided statement<sup>6</sup> in favor of the stand now taken by the Lords' Committee. The problem had arisen in subsequent crises, but it had never become an established policy with the Bank to meet a panic demand for accommodation with liberal credits. In each case the Bank had only taken such action as a desperate last resort.

The main defense of the Act advanced by the Currency School was that it had

<sup>4</sup> The views expressed in the *Lords' Report*, including particularly the recommendation for a relaxing clause, were widely supported. Among those holding such views were: Lord Ashburton (Francis Baring), *The Financial and Commercial Crisis Considered*, 3rd. ed.; London, 1847, pp. 11-17; two Liverpool business men, Hodgson and Turner, see their evidence given before the *Commons Committee of 1847-48*, qs. 389-405, 370-372, 672-675; John Inchbald in *The Price of Money*, London, 1862, pp. 17-21; and R. H. Mills, *The Principles of Currency and Banking*, 2d ed.; London, 1857, p. 80. See also a "Petition to Parliament of the Merchants, Bankers and Traders of London," reprinted in Overstone's *Tracts*.

<sup>5</sup> Cf. Overstone's evidence before the *Commons Committee of 1847-48*, qs. 1440, 1456-1461, 1514, 1551; the evidence of Morris, the Governor, Prescott, Deputy-Governor, and J. W. Norman, director of the Bank of England, before the *Commons Committee of 1847-48*, qs. 2718 ff. and qs. 2798-2803. Other important authorities whose views helped to prevent the adoption of a relaxing clause when the Bank Charter came up for renewal in 1858 were Sir Robert Peel and Neave, the governor of the Bank in that year. For Peel's views see Tooke and Newmarch, *op. cit.*, V, 499, and for Neave's, *Committee of 1857-58*, qs. 394-395.

<sup>6</sup> *The Bullion Report*, 1810, p. 40.

provided satisfactory safeguards for the convertibility of the currency.<sup>7</sup> Furthermore, it was declared, these safeguards were sound in principle, inasmuch as they represented an application of the principles of a purely metallic currency. All objections to the Act on the grounds that it was too restrictive, encouraged speculation, failed to prevent booms, or caused too frequent and violent changes in the rate of interest, were in this manner easily disposed of by the Currency School. They pointed out that any phenomena which occurred under the Act of 1844 would also occur with a metallic system and that the Act was not intended to do more than to cause the currency to operate as a metallic one would have done.

The Currency School contended that the Act had secured convertibility by forcing the Bank to keep a larger stock of bullion on the average. They emphasized the argument that by this means not only was the danger of actual exhaustion of the reserves averted, but also any *apprehension* that the Bank was likely to lose all its gold. Referring to the events of 1847 Overstone declared that had it not been for the Act, serious alarm with regard to the safety of the monetary system would probably have intensified the crisis as, in his view, had happened on occasions before 1844.<sup>8</sup>

There is reason for accepting the Currency School view that the Act had protected the reserves of the Bank. Overstone was able to point out in 1848 that the gold in the Bank had not fallen below six million pounds in 1847, as compared with the almost complete exhaustion of the years 1825 and 1839, and furthermore that under the Act the Bank was obliged to take steps for protecting its reserves earlier than it had done before the Act.<sup>9</sup> It had to restrict its advances and raise the discount rate as soon as the comparatively small reserve applicable to the deposits was threatened; and this happened before the bullion in the Issue Department had been much reduced, since nearly all the notes returned to the Issue Department meant an abstraction of so many notes from the Banking reserve.

Although much disappointment was evidently felt with the results of the Act of 1844, there still remained a large body of opinion which was in favor of its continuance. To begin with, the leading members of the Currency School continued to be influential and active on behalf of the Act for the first twenty years of its life. Norman was still a Bank director; Torrens wrote a large volume defending the Act;<sup>10</sup> and Overstone, whose prestige was tremendous,

<sup>7</sup> On what follows cf. Overstone, *Commons Committee of 1847-48*, qs. 5117, 5142; Morris and Prescott, *ibid.*, q. 2717; Cotton (a Bank director), *ibid.*, q. 3934; David Salomons, *Committee of 1857*, q. 1196; Thomas Weguelin (Governor of the Bank from 1853-1857) *ibid.*, q. 287; John Inchbald, *op. cit.*, pp. 15-16; Charles Neate, *Two Lectures on Currency* . . . Oxford, 1859, p. 39; George Combe, *The Currency Question* . . . 6th ed., London, 1856, p. 38 ff; R. H. Mills, *op. cit.*, pp. 109 ff.

<sup>8</sup> *Report from the Secret (Commons) Committee on Commercial Distress (1847-1848)*, q. 5117.

<sup>9</sup> *Ibid.*, q. 5142.

<sup>10</sup> *The Principles and Practical Operation of Sir Robert Peel's Act of 1844*, 3d ed.; London, 1858.



appeared before all the Committees. The leading Bank directors had adopted the Currency School position, and there were many new names to add to the list of Currency School writers—notably John Inchbald,<sup>11</sup> Charles Neate,<sup>12</sup> George Combe,<sup>13</sup> and R. H. Mills.<sup>14</sup> Neate was a professor at Cambridge and Mills at an Irish University. Their writings consisted of published lectures in which, it is interesting to observe, Currency School theory was outlined as the approved doctrine of the day. George Combe championed the cause of the Currency School in a pamphlet which was received with great acclaim by the Times, and which quickly ran through six editions within a year.<sup>15</sup> The three Parliamentary Committees were in favor of the continuance of the Act, though one, the Lords' Committee, wanted some modification of it as indicated above. Even Wilson, as a member of the 1857–1858 Committee, cast his vote with the majority in approving the Report which, on the whole, spoke favorably of the Act.

Against this weight of favorable and semi-favorable opinion may be set the adverse judgment of only a few important figures of the time, namely, Tooke,<sup>16</sup> Newmarch who collaborated with Tooke on the later volumes of the *History of Prices*,<sup>17</sup> John Stuart Mill,<sup>18</sup> and Cairnes.<sup>19</sup> It is not surprising therefore that no changes were made in the Act of 1844 at this time.

### III

The purpose of this section is to attempt an evaluation of the theories and actual proposals of the two schools.

The Banking School did not succeed in overturning the doctrines of their opponents as regards the relation between money and prices. In the first place, too much attention was given by the Banking School to refuting the theory, allegedly the essential part of the Currency School doctrine, that banks could directly regulate the volume of notes in actual circulation and could thus regulate prices. Too little space was given to appraising the view that prices could be influenced through the regulation of the total supply of money of which notes were only a part. That part of Banking School theory which did apply to this question contained some elements of significant criticism but also some definite fallacies. The latter is true, for instance, of Fullarton's doctrine of loan and reflux, and of the distinction made between the effects of an influx of gold from the mines (which it was contended *would* raise prices) and the effects of an influx

<sup>11</sup> *The Price of Money*, 1862.

<sup>12</sup> *Two Lectures on the Currency*, 1859.

<sup>13</sup> *The Currency Question Considered*, 1856.

<sup>14</sup> *The Principles of Currency and Banking*, 2d ed., 1857.

<sup>15</sup> *Op. cit.*

<sup>16</sup> In his *History of Prices*, Vols. IV and V and his evidence before the *Secret (Commons) Committee on Commercial Distress* (1847–1848).

<sup>17</sup> Vols. V and VI (1857).

<sup>18</sup> In his *Principles* and his evidence before the *Commons Committee of 1857 on Bank Acts*.

<sup>19</sup> In *An Examination into the Principles of Currency Involved in the Bank Charter Act of 1844* (1854).

of gold which was part of the previously existing supply (which it was said could not have a causal effect on prices).<sup>20</sup>

Furthermore, the theories of the Banking School suffered from being very obscure at crucial points. A study of the literature leads to the conclusion that whereas it is easy to describe the Currency theory because it formed an intelligibly connected set of ideas, the Banking School views were far from constituting a coherent or unified theory. It is, in fact, easier to say what they were not (that is, to point out the erroneousess of certain interpretations which might suggest themselves at a first reading of the literature and have sometimes been advanced), than to characterize them definitely. For example, the literature seems to contain little to support a characterization of Banking School views as a theory that if loans were made only on short-term securities representing real transactions, the increase of money in circulation would never outrun the increase in production. The Banking School did think that the increase in money could outrun production; it could and should do so at times when prices weretending to rise in sympathy with a business revival or for other reasons. Neither can it be said that the Banking School rejected the concept of a general price level as unreal and would discuss only the causes of changes in the prices of particular commodities. They had a great many ideas on the causes of changes in the price level. Finally, they did not, at any rate consistently, indicate that in their view the demand for loans was inelastic in relation to the rate of interest.

It appears also that almost any explanation of Banking School views which is appropriate at one point will turn out to be inapplicable at another, and a search for some implicit idea which would form a key to their whole position is not likely to be successful. Perhaps the most consistently underlying idea was that "capital" and "credit" and not the actual means of payment formed the limits of immediately available purchasing power. These writers failed to see that at any given time the extent of purchasing power which could be used was to be measured by the volume of what was customarily accepted as money in the community.

A second, very important, source of disagreement between the two Schools over the quantity theory in its application to short-run, cyclical fluctuations of prices, seems to have been the Banking School view that the extent to which purchasing power would be used depended mainly upon business men's profit anticipations.<sup>21</sup> It seems to have been recognized, however, that decisions with regard to business ventures were shaped to some degree by the conditions of supply of capital and credit. Hence, as noted above, it would not be true to say that they believed the demand for loan funds to be completely inelastic.

<sup>20</sup> Fullarton, *op. cit.*, pp. 62-64, 81, 126-28.

<sup>21</sup> The Currency School, it must be noted, gave a place to "anticipations," but they were mainly concerned with the role of the latter in inducing bankers to participate in general business optimism by expanding their note issues. They underestimated the difficulty of currency expansion or contraction at times when business psychology was running in an opposite direction.

The views of the Banking School on "anticipations" might have been incorporated into the theories of the Currency School to great advantage. The emphatic claims of the Banking school that capital and credit ought to be carefully distinguished from currency appear, however, to have formed no contribution to monetary theory. These writers seem to have failed to recognize fully an important connection which exists between capital and currency. They glossed over the point that banks were simultaneously suppliers of capital and creators of money and could alter the supply of the former by altering the supply of the latter. This was an idea which was involved in the Currency theory but was not clearly developed, so that an important source of disagreement in this controversy never came to the surface.

While much of the Banking School reasoning as regards the relation between money and prices was fallacious, their criticism that the Currency School made the mistake of overemphasizing the role played by bank notes in the monetary system was correct. There can be no doubt that in this respect the Currency School led many of their contemporaries to expect more from the Act of 1844 than was actually achieved. The Currency School aim of reducing business fluctuations could not be realized by their simple rule providing for the regulation of bank notes alone, even if internal stability and international equilibrium had been harmonious objectives. The fact that Bank of England notes were an important element of other banks' reserves did not, for several reasons, afford the Bank adequate powers to regulate deposits. In the first place, since the reserves of satellite banks consisted of deposits at the Bank as well as of notes and coin, it was possible for the reserves of the former to remain the same while their holdings of Bank of England notes varied; and, of course, the opposite might occur. Hence the total liabilities of satellite banks might vary independently of the Bank's note issues. A second, most important factor introducing elasticity, was that the Banking Department of the Bank might allow its reserve ratio (notes to total liabilities) to vary. As already indicated, the Banking Department made little attempt to keep a constant reserve ratio in the period after the passage of the Act discussed above. Thirdly, changes in the opinions of bankers as to what was a safe reserve ratio for their banks might act to frustrate attempts to control the volume of money through the note issues. Finally, the public might elect to change the proportion of notes in circulation to bank deposits. Changes of this kind would assume particular importance for the Currency School if it were found that they corresponded with fluctuations of business activity. When there is added to all these sources of divergence between notes and deposits the possibility that variations in the velocity of turnover of money might offset changes in its volume, it is clear that regulation of Bank of England note issues was a far cry from regulation of the value of money.

We have seen that most members of the Currency School accepted the idea that deposits were means of payment. It was not because of failure to recognize this fact that they did not want to have deposits regulated. They defended their proposal for the regulation of notes alone with two main arguments. First,



they said that as far as legislative reform was concerned they wished only to make the mixed currency operate as a metallic system would have done. (By a metallic system they meant one in which coin was used instead of notes but which in other respects was like the currency of their day.) In the second place, the Currency School contended that it would be extremely difficult to regulate deposits, and they did not favor extensive interference with free banking. In other words, the regulation of notes was an improvement over no regulation at all.

As regards the actual working of the Act during the two major crises of 1847 and 1857, it seems fair to conclude that the main objective of the Currency School, that of securing the convertibility of the note, was substantially realized. Under the terms of the Act the Bank of England was obliged to restrict credit and raise the discount rate at an earlier stage of a gold drain than would have been the case without the Act. The assertions of the Currency School on this point were supported by the complaints of their opponents.

This earlier action had not, however, carried with it the advantage expected of it by the Currency School. It had not made for more gradual action. It was still, as contemporaries pointed out, entirely at the discretion of the Bank directors whether or not they acted at the beginning of a drain or waited until the reserve situation in the Banking Department necessitated the application of severely restrictive measures. Had the directors acted up to the fullest expectation of the Currency School and raised the discount rate at the very beginning of a drain on their reserves, more gradual deflation might have been possible. Even so the rate at which the drain proceeded on some occasions was such that with the division of the Bank into two departments and the small amount of gold thus left as the operating reserve for the Banking Department, the measures required must necessarily have been drastic. For example, during the financial strain of 1847 the Banking Department lost more than two-thirds of its reserve within three months. Later in the same year, after a brief recovery, the reserve fell from four million pounds to one million in the space of one month.

The violence of these percentages of variation are not surprising when we remember how small were the absolute amounts of the reserves, even at their best. The Banking School were right in their contention that the reserves of the Bank of England were inadequate and that their inadequacy was intensified by the division of the Bank into two departments. As just noted, larger reserves would have made possible a more gradual restriction of credit during gold drains and would have prevented those disruptions of confidence which arose out of fears that the Bank's capacity to lend would be exhausted. Larger reserves would also have given the Bank greater powers to use discretion in its treatment of gold drains.

The Currency School response to complaints that the Act deprived the Bank of the power to differentiate between different types of drains was that the Government could in an extreme emergency authorize the suspension of the Act. This did not fully meet the difficulty, however, for the principle was at the same time established that the lifting of the fiduciary limit should only be permitted

with the greatest reluctance and after a crisis had arrived rather than in order to prevent the occurrence of one. Hence it is clear that the policy of granting liberal advances to support confidence could not be used to its fullest advantage.

## IV

Enlargement of the Bank's reserves continued to be urged by many in the long period, 1844 to 1914, during which the Act of 1844 remained unchanged.<sup>22</sup> Throughout most of this period the basic ideas of the Currency School held sway, for the narrowness of the reserves enforced close attention to gold drains on the part of the Bank of England.

From the experiences of 1847 and 1857 emerged the definite realization that the Bank of England was not relieved by the Bank Charter Act from the responsibilities of monetary control.<sup>23</sup> In 1866 it was necessary again to suspend the Act, but thereafter commercial crises became less severe and panics were avoided. The Bank gradually learned how to operate under the Act, in other words, how to protect its reserves by systematic regulation of its discount rate and the use of other devices, particularly open market operations. In the first part of the period after 1844 the problem of protecting the reserves was made easier by large importations of gold resulting from the Californian and Australian discoveries. After 1870, however, the smallness of the reserves was again a conspicuous factor in the situation, and for most of the period 1870 to 1904 the Bank of England relied heavily upon discount and related policies to control gold flows. The increasing sensitiveness of the international money market to Bank of England policy made control easier, but the Bank's discount rate continued to show marked variations.

The unsteadiness of the Bank rate appeared to many critics to represent an unnecessary sacrifice of internal stability for the sake of maintaining international equilibrium. These critics followed the ideas of the Banking School in emphasizing the importance of stable credit conditions and urging the enlargement of the Bank's reserves or the use of other means for cushioning the impact of gold drains. Since 1914 such views have gained ascendancy and have been reflected in legislation and in reports of Parliamentary Committees.

<sup>22</sup> On the operation of the Bank Act during the years 1857 to 1914 see particularly, R. G. Hawtrey, *A Century of Bank Rate*, 1938, chaps. ii, iii; W. Edwards Beach, *British International Gold Movements and Banking Policy, 1881-1913*, 1935, particularly pp. 38-39, 154, 168-169; T. E. Gregory, *Select Statutes, Documents and Reports Relating to British Banking, 1832-1928*, Introduction, pp. xxxix-xl.

<sup>23</sup> Or perhaps it would be better to say money market control. There seems to be considerable evidence that after 1844 opinion shifted rather generally to the belief that the Bank's responsibilities derived from the fact that its *capital* resources were so large. The monetary aspects of control were rather neglected. This is one of the main conclusions of Elmer Wood's *English Theories of Central Banking Control, 1819-1858*, Cambridge, Mass., 1939; see particularly pp. 122-24, 178. The Banking School and others had always seen Bank policy from a *capital* rather than *currency* angle. The Currency School after 1844 were more ready to accept this view because they held that the Act of 1844 had substantially established automatic control of the *currency*.

In 1918 the Cunliffe Committee, while it approved the principle of the fixed fiduciary issue, at the same time recommended that the powers given to the Treasury by the Act of 1914, which authorized the Bank temporarily to issue notes in excess of the statutory limit, should be adopted as a permanent part of the law.<sup>24</sup> The Currency and Bank Notes Act of 1928 was framed accordingly.<sup>25</sup> Furthermore, during the passage of the Bill it was expressly stated by the Government that the relaxing clause was "intended to be used, not reluctantly and with hesitation in times of crisis, but whenever the Governor of the Bank feels that the present limit on the fiduciary issue is unduly restrictive. . . ."<sup>26</sup>

In the opinion of the Macmillan Committee of 1930-1931, however, the Act of 1928 had not gone far enough. In their Report a further step was taken as a result of which their views appear to resemble very closely the position held by Tooke and others of the Banking School. The Report stated that circumstances might well arise that were far from emergency conditions, in which it was desirable to let gold flow freely from the country.<sup>27</sup> It was pointed out that under the fixed fiduciary issue and separation of departments the reserve of notes in the Banking Department was in effect the measure of the maximum amount of gold which the Bank could lose without a change in the volume of notes in circulation.<sup>28</sup> The gold in the Issue Department was immobilized and could not be used for export. The Report concluded that "the task of reconciling international exchange stability with domestic credit stability will be made easier, if the Central Bank is free on occasion to allow wider fluctuations in the proportion of its total assets which is made up of gold and comparable items."<sup>29</sup> The Committee therefore recommended that the fixed fiduciary issue and the separation of the Bank into two departments should be discontinued.<sup>30</sup>

## V

Certain more general thoughts arise from a consideration of the issues involved in the Currency-Banking controversy and of subsequent developments in monetary doctrine. It has already been suggested above that the Banking School showed better judgment than the Currency School in some of their practical recommendations regarding central banking policy, particularly their plea for larger metallic reserves. It may be worth while also to offer the conclusion that the Banking School position in the history of monetary theory is not adequately appraised if these writers are thought of only as the forerunners of the more modern "elastic-currency-short-term-commercial-credit" school, with which one associates the names of Laughlin, Willis and Beckhart as important exponents.

<sup>24</sup> Great Britain, House of Commons, *Report of the Committee on Finance and Industry, Parliamentary Papers*, Vol. XIII (1930-1931), p. 27.

<sup>25</sup> *Ibid.*, p. 28.

<sup>26</sup> *Ibid.*, p. 139.

<sup>27</sup> *Ibid.*, p. 140.

<sup>28</sup> *Ibid.*, p. 30.

<sup>29</sup> *Ibid.*, p. 141.

<sup>30</sup> *Ibid.*, pp. 142-47.



There are other quite different and important modern developments which the Banking School may easily be thought of as foreshadowing. One such connection has already received considerable attention in recent writings, that is the relation of Tooke's income theory of prices to the income approach in later Swedish and English monetary theory. It is to be noted also that the general tenor of Banking School thinking, with its emphasis on entrepreneurial and consumer effective demand rather than on the quantity of money, and on entrepreneurial anticipations rather than on the rate of interest, seems to have anticipated in a broad way many of the most significant features of the Swedish and Keynesian break with the  $MV=PT$  type of analysis.

It is necessary, of course, to guard against overrating the Banking School in this connection, and the student of their writings may feel that he should discount many apparent anticipations of modern theories on the grounds that these anticipations appeared among a mass of obscure, disorderly, and often fallacious ideas—the generally unfavorable impression being heightened by the juxtaposition of Banking School writings with the clearcut presentations of the Currency School. But it is also to be remembered that while the Currency School were offering a point of view which had a long history of systematic development behind it and was already mature, the Banking School were working in hard and relatively unfruitful fields where new lines of thought were only just beginning to germinate.







